3.04 HTM Debt Securities & Equity Securities

Accounting for Held-to-Maturity Securities

HTM Securities are investments in the debt securities of other entities that the entity has both the intent and the ability to hold until maturity. Securities are considered held to maturity if sale occurs after at least 85% of principal has been collected.

In the rare case that these securities are not held to maturity, an ordinary gain/loss results on disposal. This would be true, for example, when the issuer of the debt security exercises a call provision, compelling the investor to redeem them early. If the future exercise of a call provision on a purchased callable debt security is considered likely, any premium is required to be amortized over the period from purchase through the expected exercise date.

Balance Sheet

HTM securities are initially recorded at cost and then carried at amortized cost (ie, face amount, net of unamortized discount or premium).

- The difference between the cost and the face/maturity value is amortized over the life of the security, using the effective rate method (discussed later in the bonds section); however, the straight-line method may be used if it doesn't materially differ.
- Since HTM securities are not going to be sold, fluctuations in market price are disclosed but not recorded.

HTM securities are generally considered noncurrent assets unless the maturity date is less than one year from the balance sheet date.

Any allowance for credit losses is reported separately from the amortized cost of the financial asset on the balance sheet.

There are no unrealized gains/losses with respect to HTM securities.

Income Statement

- The increase/decrease in the allowance for credit losses will be reported on the I/S in the period of the change as credit loss expense or reversal of credit loss expense, respectively.
- Realized gains/losses should not happen but could.
- Report interest income net of amortization on the income statement.

Statement of Cash Flows

The cash effects of purchases (outflows) and sales or redemptions (inflows) of HTM securities are classified as investing activities on the statement of cash flows.

In addition to the three methods of accounting for and reporting investments in debt securities, the investor may elect to apply the fair value option. Under the fair value option, the securities will be reported at FMV (B/S) and both realized and unrealized gains/losses will be reported as a component of income from continuing operations (I/S).

Investments in Equity Securities of Other Entities

ASC 321 applies to most investments in equity securities of another entity and to other ownership interests, such as investments in partnerships, unincorporated joint ventures, and limited liability entities as if those interests were equity securities. It does *not* apply to:

- Investments accounted for under the "adjusted cost method" or the equity method (discussed later)
- Investments in consolidated subsidiaries
- A membership in an exchange representing an ownership interest in the exchange
- Federal Home Loan Bank and Federal Reserve Bank Stock

Balance Sheet

Investments in equity securities are originally recorded at cost but are adjusted to fair value each balance sheet date (ie, the fair value approach). If the fair value is not readily determinable, then we use the "adjusted cost method" (discussed later), which is cost minus any impairment losses.

On the balance sheet, the classification of these investments will be determined by the measurement category they fall into, either current or noncurrent assets, as specified in ASC 825, *Financial Instruments*.

Income Statement

Unrealized gains/losses (temporary) are reported as a component of income from continuing operations. This is the same as the accounting for investments in debt securities classified as trading securities.

Realized gains/losses are always on the income statement along with interest and dividend income.

Statement of Cash Flows

On the statement of cash flows, the classifications of cash flows related to the acquisition (outflows) or disposal (inflows) related to these investments will be based on the nature and purpose for which they are acquired, either operating or investing.

Fair Value Option

As previously mentioned, ASC 825 allows an entity to value various eligible items at fair value at certain dates, referred to as election dates. Once the fair value option is elected, it is irrevocable until a subsequent election date. Eligible items include:

- Most recognized financial instruments

- Includes both financial assets and financial liabilities
- Does *not* include certain instruments:
  - Subsidiaries or VIEs required to be consolidated
  - Deferred compensation arrangements, including pension or other postretirement or post-employment obligations and stock option or stock purchase plans
  - Assets or liabilities recognized under leases
  - Deposit liabilities of depository institutions
  - Financial instruments classified as a component of stockholders' equity

- Firm commitments involving only financial instruments that would not be recognized at inception
- Written loan commitments
- Rights and obligations under insurance contracts or warranties when certain requirements are met:
  - The insurance contract or warranty is not a financial instrument.
  - The insurer or warrantor is allowed by the terms to pay a third party to provide goods or services to settle the obligation.

Election dates include:

- When the entity first recognizes an eligible item on its F/S
- The date on which the entity enters into a firm commitment
- When an item that was reported at fair value due to specialized accounting principles, with unrealized gains or losses reported in earnings, no longer qualifies for the specialized accounting treatment
- When an investment becomes subject to the equity method
- A circumstance requiring the item to be reported at fair value at a point in time but not at each reporting date, other than an impairment

An election date also occurs when *an event* requires an eligible item to be reported at fair value or to be recognized initially, such as:

- Business combinations
- Consolidation or deconsolidation of a VIE
- Significant debt modifications

The fair value option can be elected on an instrument-by-instrument basis. Electing the fair value option for a particular instrument does not require election for a similar instrument held by the same entity. This includes a circumstance where the investor holds bonds, for example, with a total face value of $100,000, allowing the investor to elect the fair value option for one portion and account for the remainder as held to maturity securities.

Some of the specific applications of the fair value option include the following:

- An investment which otherwise qualifies for the equity method would be reported at fair value on each balance sheet date, increases or decreases will be recognized as unrealized gains or losses on the income statement, and dividends received will be recognized as income. In other words, the fair value option overrides the equity method.

- HTM securities continue to be accounted for at amortized cost, recognizing interest income under the effective interest method. In addition, the carrying value is adjusted to fair value on each balance sheet date with the increase/decrease recognized as a component of net income.
- AFS debt securities will be reported at fair value on each balance sheet date, as already required. Unrealized gains or losses are reported as a component of net income, however, instead of OCI.

Note that trading debt securities are not affected.

Disclosures under Fair Value Option

When an entity elects the fair value option, certain disclosures are required as of each balance sheet date.

- Management's reasons for electing the fair value option for each item for which the election was made
- If elected for some, but not all, items within a group of similar items, a description of the similar items, the reasons for a partial election, and how the similar items affect line items on the statement of financial position
- The differences between fair value amounts and principal balances of receivables or payables with contractual principal amounts
- Disclosures required when applying the fair value option for investments that would have been accounted for under the equity method if the fair value election had not been made

Disclosures are also required for each period for which an income statement is presented:

- Amounts of each gain or loss recognized in earnings as a result of changes in fair values
- An indication as to where interest and dividends are reported on the income statement and how they are measured
- For receivables held as assets, the gains or losses resulting from changes in the instrument's credit risk, including how it is measured
- For liabilities affected by changes in the instrument's credit risk during the period, the gains or losses resulting from changes in the instruments credit risk, reasons for the change, and how the gains or losses are measured